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Some Notes on Corporations and on Auditors in Germany Under the Emergency Decrees

By FRANCIS J. H. O'DEA

"And how his audit stands who knows save heaven" (*Hamlet, Act III, Scene III*)
"To make their audit at your highness' pleasure" (*Macbeth, Act I, Scene VI*)

From being a matter lying more or less entirely in the discretion of the directors, the audit of a German Corporation has, under the Emergency Decrees, become more strictly defined by law than is the case, perhaps, in any other country. The qualifications of the auditor, his powers, his liabilities, the extent of his examination, the form and content of the accounts and the nature of his report are prescribed in more or less detail.

The auditor's qualifications include good personal character, adequate financial and social standing, a knowledge of accounting, including costing, statistics, company promotion and administration, and of the law affecting auditors and their duties, including those parts of the civil and commercial codes with which the auditor should be familiar to enable him properly to discharge his duty to his client: for example, the provisions relating to companies, banking, bills of exchange, insurance, real estate, mortgages, debt collection, taxation, bankruptcy.

The auditor is now elected by the shareholders in general meeting. No person may be elected who is a member of the executive board, of the supervisory council (corresponding more or less to the board of directors in America), or of the staff of the corporation, or any person on whose business the corporation exercises a considerable influence.

The obligation to appoint an auditor does not apply to corporations with a capital not exceeding three million Reichsmark. Further, according to the interpretation in the latest supplement to "Staub's Kommentar zum Handelsgesetzbuch" (the standard work on the German Commercial Code) an auditor need not be appointed, when the Executive Board, Supervisory Council and all shareholders agree to the omission.

The law expressly states that the audit must not be confined to ascertaining that the annual accounts are objectively correct and in agreement with the books and inventories of the company, but must cover also the report on the year's operations which must be submitted by the administration to the general meeting.

The report on the year's operations must discuss the development during the year of the financial situation and general conditions of the corporation and comment on the annual accounts. These comments should include an explanation of any material variations from the accounts of the previous year.

The report should also disclose the relationship of the corporation to any subsidiaries, or to any other concern of which it may be a subsidiary or with which it may be affiliated.

The report on the year's operations should further provide information on the following points, insofar as they may be applicable:

(1) Shares in another company which have been taken up by a third party as founder or subscriber; such third party acting on behalf of the corporation. Should such shares have been disposed of during the fiscal year, this should also be reported and the application of the proceeds disclosed.

(2) The amount of its own shares possessed by the corporation, or held by a third party for account of the corporation; if such shares have been acquired or disposed of in the course of the fiscal year, the report must state the price paid or obtained, and indicate how the proceeds were applied.

(3) "Bound" shares (gebundene Aktien). A share is so described when the shareholder has—either by an express or tacit arrangement in favor of the corporation or an affiliated or subsidiary concern—bound (restricted or obligated) himself in the exercise of his rights as a shareholder or in his right to sell or otherwise dispose of the share.

(4) "Genusscheine" issued during the fiscal year.
The "Genusschein" is a document giving title to a share in profits and/or in the surplus available on liquidation. It is distinguished from a share in that it conveys none of the rights of a shareholder except those indicated above; it differs from a bond in that it does not represent a debt due by the corporation. Until the Emergency Decree of September 19 1931, "Genusscheine" were not mentioned in the Commercial Code, although they were frequently employed in practice. They were issued, for example, against assets of uncertain value acquired by a corporation, such as patent rights, good will or even a whole business. The object was to give the seller a right to participate in profits should the undertaking prosper, but in the event of unfavorable development not to burden the acquiring corporation with an inflated capital, or an unwieldy and perhaps unjustified liability; the method had the further advantage, as against the issue of shares, of excluding interference by the seller in the administration of the buyer. In cases where the capital of a corporation was being reduced, Genusscheine were occasionally issued to shareholders who, in the rehabilitation of the corporation, had been deprived of rights. The Genusschein held out a prospect of compensation when the affairs of the company improved.

(5) Liabilities or obligations not evident from the balance sheet, including pledges and sureties, and liabilities arising out of bills of exchange and checks given. In the past, it has been by no means rare that in the annual accounts and report, no indication whatever was given of the existence of contingent liabilities. A case might be cited where the corporation had given a guarantee for a considerable sum and the principal debtor had filed his petition in bankruptcy, but the corporation did not disclose the liablity because the receiver in bankruptcy had not yet made his claim. There is no doubt that this particular provision contains the germ of many unpleasant surprises for shareholders.

(6) The total amounts drawn by members of the executive board and of the supervisory council (salary, proportion of profit, representation expenses, commission, and any other perquisites).

(7) The membership of the corporation in any association, union or similar organization whose object is the regulation of prices or turnover. The cartels are the chief organizations aimed at here.

(8) Any events of special importance which may have occurred subsequent to the end of the fiscal year.

The above information, so far as applicable, may be omitted only to the extent that this is required by the pre-

ponderant interest of one of the companies concerned or of the public. This last provision is bound to create considerable difficulty. Those directors who, in the past, have been somewhat less than frank with their shareholders, will be tempted to find reasons for believing that continued silence is greatly to the interest of their corporation or the public good. On the other hand they may be called upon to satisfy a court of the validity of their reasons, with the possibility of claims for damages or even criminal proceedings in the event of failure. The clause itself would appear to be an indication of a reaction in the mind of the legislator. The cry for greater publicity had been the result of a series of crashes of large and well-reputed concerns, whose preceding statements had given no indication of the factors which eventually culminated in downfall. Against the clamor for fullest information, the principle was expressed that industry is entitled to the protection of the state, even to the detriment of individual shareholders. Apart from the insertion of the clause under discussion, the original draft of the measure was modified by the omission of certain provisions. For example, the draft contained the stipulation that the report should indicate: "Losses which will probably arise from the subsequent fulfilment of existing contracts for delivery or acceptance or otherwise."

So much for the report of the year's operations, which the auditor must examine and, if necessary, criticize.

The auditor is authorized to require from the executive board all explanations and all evidence which may be required for a careful and efficient fulfilment of his duties. He must make a written report on the result of his examination. This report must state whether the books of the company, the annual accounts, and the report on the year's operations conform to the requirements of the law; and whether he has obtained all the information, explanations and evidence he required.

The auditor's report is to be submitted to the supervisory council, who shall comment on it at the annual meeting of the shareholders and draw attention to any unfavorable criticism.

The duty imposed on the auditor of conscientious and efficient work is reenforced by a penalty up to RM 100,000 for proved negligence.

As mentioned briefly in the opening paragraph, the form and content of accounts has also been prescribed. There is a general statement to the effect that the annual accounts are to be so clearly set out that they will furnish to interested parties the fullest possible information on the condition of the affairs of the corporation.

Dealing first with content, the following rules are to be observed concerning individual items in the balance sheet:

(1) Plant and other assets, destined to the continuous use of the corporation, may be inserted in the balance sheet at the cost for which they were acquired or manufactured (ignoring a lesser effective present-day value), less deduction of an amount in respect of depreciation and obsolescence calculated and apportioned over the estimated useful life of the asset. The deduction may appear as such on the face of the balance sheet or may take the form of a reserve account. In computing the cost of manufacture, a reasonable sum may be added in respect of depreciation (of plant, tools etc. employed in

manufacture) and a reasonable proportion of the factory and administration overhead costs, applicable to the period of manufacture. In computing such figures care must, therefore, be taken to exclude any expenses which are, properly speaking, expenses of distribution.

Securities destined to the continuous use of the corporation may be inserted at the cost at which they were acquired (ignoring a lesser effective present value), unless good accounting principles demand the re-adjustment of this figure. This is another instance where the interpretation of the legal provision is left largely to the individual judgment.

(2) Securities and other assets which are not destined to the continuous use of the corporation, as well as merchandise inventories and the corporation's own shares, must be inserted at not more than the cost for which they were acquired or manufactured. If the cost at which they were acquired or manufactured exceeds the market value at date of the balance sheet, a valuation not higher than market price is to be employed. In other words, for these assets the accounting principle "cost or market, whichever is lower" defines the maximum valuation.

Should a market quotation not be available, the valuation for balance sheet purposes should not exceed the lower of cost of acquisition or manufacture on the one hand, and estimated effective value at balance sheet date on the other.

(3) Formation expenses, and expenses arising from increase in capital, may not be shown as assets of the company.

(4) Normally, goodwill may not be included among the assets of a corporation. Should, however, the corporation acquire a business and should the price paid therefor exceed the surplus of the assets over the liabilities of that business when taken over, the difference may be shown separately under the assets in the corporation's balance sheet, and be charged to Revenue in reasonable yearly instalments. This may be expressed shortly by saying that created goodwill may not be capitalized, but that objection will not be raised to purchased goodwill appearing as an asset for a reasonable period. What is a reasonable period in this connection is not specified. Professor Smalenbach, a recognized German authority on accounting, has stated that ten percent is generally assumed to be a reasonable write-off. He adds, however, that this is more arbitrary than exact.

(5) Loans received by the company are to be inserted in the balance sheet at their repayment amount. Should this latter exceed the issue price, the difference may be inserted as a separate item on the assets side of the balance sheet and written off in yearly instalments over the period of the loan. Two points may be observed here. First, the difference "may,"—not "must",—be inserted on the assets side of the balance sheet. The corporation is, therefore, at liberty to charge the total discount on the loan to the revenue of the year when the loan is taken up. Be it noted, however, that this privilege does not modify any tax regulations in force governing admissible and inadmissible charges against profits. Second, "yearly instalments" are specified; it is not prescribed that such instalments shall be equal in amount. There may, therefore, appear to be no objection on a strict legal interpretation to the corporation charg-

ing varying amounts each year according to the opinion of the administration, provided always, of course, that the full amount had been written off by the date when the loan fell due for repayment. Nevertheless, if a policy of varying write-offs were adopted, it would seem that attention should be called, in the report on the year's operations, to the effect of this on the results shown.

(6) The amount of the capital is to be shown under the liabilities at its nominal value. (See below.)

Regarding the form of the balance sheet, the Emergency Decree of September 19, 1931 provides that, unless the nature of the corporation's business renders a different allocation necessary, and without precluding further subdivision, the following items shall be shown separately:

A. On the assets side.

I. Capital unpaid.

Unlike some other countries, where it has been the practically universal practice to show the net amount of paid-in capital in the ultimate column on the liabilities side of the balance sheet, German accountants have preferred to show the total issued capital on the liabilities side and the claims against shareholders as an asset. With this provision, therefore, the government merely bestows its blessing on the accepted practice in Germany. The question of capital authorized but not issued (as distinct from treasury stock) does not arise, as German corporation law makes no provision for such authorization.

II. Plant assets.

1. Land.

2. Buildings.

(a) Offiices and dwelling houses.

(b) Factory buildings and other erections.

This may present problems where, as is often the case, land and buildings have been acquired as a single complex, and separate valuations are not available. It is presumably not the intention of the legislator to lay upon corporations at the present time the burden of an expensive appraisal. In such cases the method may be adopted of calling attention in the report, either of the executive board, or of the auditor, to the unavoidable divergence from legal prescription.

Whether this standpoint will be adopted by the executive courts remains to be seen. The object aimed at in the allocation is obviously the separation of permanent from temporary values, and providing a basis on which depreciation, write-offs and reserves may be judged. This is, in itself, sufficiently important in cases where such plant assets form a considerable portion of the total assets of the corporation.

3. Machine and machine installation.

4. Tools and works and office fittings and furnishings.

5. Concessions, patents, licenses, trade marks and similar rights.

Regarding this last item, it may arouse comment that the least tangible are grouped with the most tangible assets. Possibly the underlying connection is in the idea that it is of little profit to possess any of the rights detailed under 5 unless one has the plant to exploit them.

III. Holdings in subsidiary companies.

This includes securities which have been acquired with the object of eventually obtaining control. In cases

of doubt, a holding which amounts to one-fourth of the capital of the company whose shares are held, is considered to have been acquired with the object of obtaining control.

IV. Current assets.

1. **Raw materials.**
2. **Goods in process.**
3. **Finished goods; merchandise.**
4. **Securities, in so far as they are not included under III above or IV (5). Notes receivable and checks are also expressly excluded.**
5. **Treasury stock, indicating nominal value.**
6. **Mortgages and similar assets.**
7. **Payments on account to suppliers and others.**
8. **Trade debtors.**
9. **Claims against subsidiary or affiliated companies.**
10. **Claims against members of the executive board; or against legal representatives of subsidiary or affiliated companies; against the husband, wife or minor child of such persons; against third parties acting on behalf of any of these.**

It will be observed that claims against members of the supervisory council (whose functions are analogous to those of the board of directors in America) are not specified. In the draft of the Decree, such claims were mentioned in the paragraph corresponding to that just given, but the Decree as promulgated omits them.

11. **Notes receivable.**
12. **Checks.**
13. **Cash, including balances with banks of issue and on postal check account.**

The inclusion with actual cash of balances with banks of issue and on postal check account is presumably intended to segregate "safe" liquid funds from those which may not be quite so safe.

14. **Other bank balances.**

V. Items which serve to delimit the accounting period.

This was probably intended to cover prepaid expenses and any deficit.

B. On the liabilities side.

I. Capital.

The total nominal amount must be shown. When the shares are of different classes wherein some are preferred before others each class is to be shown separately; and when certain shares convey voting powers greater than others of the same nominal value the total numbers of votes accruing to these must be shown separately against the total number of votes accruing to the shares not so preferred.

II. Reserves.

1. **Legal reserves.**
2. **Other reserves.**

In Germany as in a number of other countries the creation of a reserve is legally imposed on the corporation. German corporation law specifies that there shall be placed to reserve:

(a) At least one-twentieth of the annual profit, until the reserve has reached one-tenth of the nominal capital, or such higher figure as the articles of the corporation may require,

(b) the amount by which the premium received on shares issued exceeds the nominal value and the expenses of issue

(c) the amount of additional payments made by shareholders representing not an increase in capital, but an equivalent for

preferential rights granted to existing shares, in so far as it has not been decided to employ these payments to cover extraordinary writedowns or extraordinary losses,

(d) the nominal value of its own shares placed at the disposal of the corporation for cancellation; or cancelled by the corporation and charged to available profit or to a reserve account,

(e) the book profit on its own shares acquired within six months prior to cancellation.

III. **Provisions.**

IV. **Value adjustment accounts (depreciation reserves and so forth).**

V. **Liabilities.**

1. **Loans, stating any security hypothecated therefor.**
2. **Mortgages and similar liabilities, excepting those which serve as security for loans, and those which represent a blanket security (so-called "Sicherungshypotheken," the registry of which is not accepted as evidence of a debt, and the claim under which depends on a liability otherwise proved).**
3. **Payments on account by customers.**
4. **Trade creditors.**
5. **Liabilities to subsidiary and affiliated companies.**
6. **Liabilities under bills of exchange.**
7. **Liabilities to banks.**

The net profit or loss for the year is to be shown at the end of the balance sheet in one sum, and separate from any surplus or undivided profit carried forward.

The following further provisions concerning balance sheet items occur in the Emergency Decree:

In the case of plant assets and of holdings, additions and deductions are to be shown separately for each subheading; the setting-off of receivables against payables (a practice which was not uncommon) is forbidden—as also the offsetting of rights against burdens on real estate when not based on a personal claim; the amount of reserves, provisions or value adjustment accounts may not be included among the liabilities. Items of receivables or payables which might be allocated to a number of different headings should bear an annotation indicating the other headings to which they might but in fact have not been allocated, should this be necessary for a clear understanding of the balance sheet. The corporation's own shares possessed by it may not be inserted under any other heading.

Obligations under sureties, including those in respect of bills of exchange and checks, as well as those arising from contracts of warranty—and even if a counterclaim of equal value exists—are to be noted on the balance sheet at their full amount.

The form of the balance sheet, as has been seen, is in many respects not unlike that in fairly common use in the United States. The statement of earnings, however, is still retained in the old "account" form. The progressive earnings statement, so widely used in America, is rarely seen in Germany. In the past, the amount of information to be obtained from most profit and loss accounts published in Germany, was negligible. It was not rare to find accounts wherein "Gross Profit," "Expenses," "Net Profit" constituted almost the sum of the information

granted. Although the Decree of September 19, 1931, provides for a certain allocation of expenses it will be seen that the form prescribed is not ideally informative. On the expenses side are to be shown:

(1) **Wages and salaries.**
(2) **Social contributions.**
(3) **Depreciation of plant.**
(4) **Other write-offs.**
(5) **Interest paid in excess of interest received.**
(6) **Taxes on property (assets, not merely real estate).**
(7) **All other expenses, with the exception of cost of raw materials, indirect materials and fuel; in the case of trading concerns, with the exception of cost of merchandise.**

On the profits side:

(1) **Income, under deduction of the expenses specifically excluded from item (7) above; and excepting income covered by items (2) to (5) below.**
(2) **Income from holdings.**
(3) **Interest received and other gains from investment, in excess of interest paid.**
(4) **Extraordinary profits.**
(5) **Extraordinary receipts (gifts, etc.).**

It is true that the legislator has stated that the above scheme does not preclude further subdivision. It is, however, probable, that in this as in other instances, the minimum legal requirement will frequently be the maximum performance.

Numerous criticisms might be made of the set-up proposed. For example item (1) on the expenses side may be a composite of administration, manufacturing, selling and any other wages and salaries. Item (1) on the profits side shows sales less cost of materials. As cost of materials may vary from under one percent to over ninety-nine percent of the cost of the product, the ordinary shareholder is not helped much. Since the composition of these two items is not divulged, it is difficult to understand why it was necessary for social contributions to be shown as a separate item, as this is merely an addition to wages, forced on the employer by the state. A possible reason was the desire to obtain statistical material at minimum cost.

Prior to the passing of the Emergency Decrees, the safeguarding of shareholders and creditors had not been completely ignored in the German Commercial Code. As a matter of interest, two provisions which are still in force may be mentioned here; they are not paralleled in English or American law so far as the writer is aware.

(1) When an annual balance sheet, or any interim statement, indicates that the corporation has lost one-half of its capital, the executive board is obligated to call immediately a meeting of the shareholders and place the facts before them.

(2) As soon as the corporation is unable to meet its current obligations, if this inability is not obviously of a merely temporary nature or as soon as it appears from an annual balance sheet or an interim statement that the assets no longer cover the liabilities, the executive board must file an application for bankruptcy proceedings to be opened.

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Verification of Inventories

By M. Ochis
(*Detroit Office*)

Admittedly, the inventory is usually the most difficult asset of a balance sheet to verify. Its verification is also the most important, and imperatively so during periods of abnormal conditions.

This year's prevailing business conditions have resulted generally in curtailed production, decreased sales and reduced profits or increased losses; all factors which are highly conducive to an overstatement of inventory values. The utmost care in the verification of the accuracy of inventory values is therefore of vital importance.

The overstatement of inventories may be the result of any or all of the following:

Overstatement of quantities,
Clerical inaccuracy,
Incorrect valuation bases,
Inclusion of obsolete, unsalable or discontinued items,
And the related factors of unbalanced quantities and excessive inventories.

The various methods and measures to be taken in the verification of inventories and the disclosure of any overstatement of same, may be broadly classified into the following groups:

Tests and checks as to quantities of physical inventories.
Tests and checks as to prices and valuation factors.
Tests and checks as to clerical accuracy.
Analytical and quantitative comparisons.
Independent scrutiny of inventory records.

The extent of the testing, checking and investigation into an inventory is largely determined by the following:

First: As a general background, there is the financial standing and profits of the organization. The concern which realizes good profits is not so apt to overstate its inventory as the one which is hard pressed for capital or is unprofitable. There also would be a tendency to the overstatement of inventories by the management of an organization where the future of the management was dependent upon or influenced by profit results.

Second: As to the internal inventory control, there are the factors of whether the cost system in use is co-ordinated with the financial accounting system; whether the purchases, production, sales and inventories are co-ordinated; whether the system of stores-keeping is safeguarded; whether stocks are counted regularly and adjustments correctly made to bring the records into agreement with the quantities actually on hand.

Third: As to the inventory taking, there are the factors of control of quantity counting, marking or tagging, checking, collection of inventory data, pricing, extending, etc.

In other words, the ideal conditions requiring the least amount of verification are those in which:

First: The concern is of such standing and the management is of a type that there is no incentive for overstatement of inventories.

Second: The cost system, stores system, internal inventory control, etc., are properly co-ordinated with the financial accounting system.

Third: The method of inventory taking is efficiently organized by specific instructions, use of responsible counters, checkers, prices, extenders, etc., and correction of all discrepancies between physical inventory and book records.

The further away from the ideal, the greater the extent of the work required to verify the inventory.

Inventory Methods: As an early step in the verification of an inventory it is well to secure a copy of the instructions governing the taking of the inventory; to ascertain the identity of persons responsible for each of the

inventory operations of counting, pricing and extending, and, if possible, to go over with them their methods of procedure.

If instructions have been thoroughly understood and carefully carried out in the performance of various operations of the inventory taking, test checks will be adequate verification under ordinary circumstances.

A study of the methods used in the taking of the inventory and a decision as to their efficiency is frequently the deciding factor in determining to what extent quantities will be checked.

For instance, if one inventory crew places on all lots of inventory material, consecutively numbered tags with description and quantity counted; if all tags are checked by a second crew; if a third crew ascertains that all items are tagged and picks up the tags; if all tags are accounted for and recorded on inventory sheets; then, a test check by physical count of a random or haphazard selection of items would ordinarily be adequate verification as to the quantities.

Quantities: Data showing original count, such as tags, stock sheets, etc., should be obtained and carefully test-checked to the inventory sheets. A reversal of this procedure by checking from the inventory sheets to the original tickets, count, etc., is advisable and necessary.

It is essential to compare the inventory with the inventory records, such as stores ledgers, work-in-process records, etc., for verification of quantities, prices and values.

Valuation: With exceptions peculiar to certain industries in which it is the trade practice to value finished goods at selling prices, the accepted method of valuation is "cost or market," whichever is lower.

The pricing of the inventory should be test-checked with recent purchase invoices or outside market quotations. The pricing must be less trade discounts.

The time of taking the latest physical inventory should be ascertained, and, if reasonably recent, such physical inventory should be checked to the corresponding book inventory records, to determine the extent of differences, and whether or not the differences so disclosed were properly adjusted on the books.

Shipping records for the last week or two of the periods under audit should be compared with customers' sales invoices to see that all stock billed was actually shipped and was not included in inventory.

It is likewise necessary to ascertain that purchase invoices for all stock included in the inventory have been entered in the books, paying special attention to post-dated invoices and goods in transit.

The inventory should only include goods the title to which is vested in the organization.

If no physical inventory has been taken at the time of examination, and the inventory as shown by the inventory records is being used, a greater number of quantity tests should ordinarily be made.

The inventory sheets should be compared in a general way with those of the previous period, for the purpose of noting any variation in the prices at which similar classes of stock are carried.

All interdepartmental or intercompany profits remaining in the inventory must be eliminated.

Goods on consignment to others, must be priced at cost, less a proper

allowance for loss, damage, or expenses of possible subsequent return.

Overhead in Inventory Value: In determining the amount of overhead in the inventory it is essential to investigate the method of determining overhead, and make certain no expenses other than factory expenses are included therein.

Ascertain that factory overhead is equitably distributed and test the method of application and rate used.

The normal overhead once ascertained, should be used to compare with the ratio used in inventory on hand. A factor that must be considered in a great many industries, particularly this year, is the production below normal. This ordinarily results in an overhead rate which is abnormally high and the use of this rate would mean deferring to future periods the absorption of considerable amounts of factory expense under the guise of inventories. The analysis of both the work-in-process and finished goods inventory as to their component elements, including a comparison of the ratios of overhead to the direct labor included therein, between the period under examination and previous periods and of the average ratio of overhead to direct labor during the period will give a good check on the reasonableness of the overhead.

Obsolete or Inactive Stock: The ratio of the closing inventory to the total sales for the year reduced to cost basis, that is turn-over, compared with that of prior years may indicate a decrease accounted for by the accumulation of obsolete and unsalable stock. The discontinuance of the manufacture of any product during the period under audit should be given particular attention in this connection.

Perpetual inventory cards and stock records should be scrutinized for inactive items.

If the product of the concern is subject to frequent style or model changes, special care should be taken to see that old styled goods are properly segregated into obsolete or service stock and correctly valued.

In determining the valuation of obsolete or discontinued items, canceled and incompleted jobs, etc., it is well to remember that, "It is a fundamental principle of accounting that known losses should be taken at once and not postponed to later periods. No item, therefore, should be included in the inventory at an amount in excess of what it will bring when sold."

Work in Process: The checking of work-in-process inventory should be left to the end. It is the most difficult to check and the one in which overstatement is likely to occur. The results of the checking of the other part of the inventory should determine the extent of checking to be done. That is, if the remainder of the inventory discloses substantial accuracy of quantity and pricing, exhaustive investigation into the work-in-process is not usually necessary. Whereas, if the contrary is the case, an extended check into work-in-process inventory is called for.

If a cost system in use is not coordinated with the financial accounting system, tests must be made to ascertain whether or not orders have been completed and billed, but possibly not taken out of the work-in-process records. This can best be done by comparing the sales for the preceding month with the orders in process included in the inventory.

Clerical Tests: The verification of the clerical accuracy of the inventory consists of verifying extensions, foot-

ings of individual sheets, comparing individual sheet totals with amount carried to summary sheets and footing of summary sheets.

In verifying extensions, particular attention should be given to decimal points and price shown. That is, whether the price shown is by unit, dozen or gross price. Quantities must be expressed in the same unit.

Ordinarily only quantities and amounts over certain minimums are checked in making tests.

In verifying inventories consisting of many sheets of items of small values, several sheets are verified and footed; and, using these values as a mental guide, the other sheets are scrutinized.

Analytic and Comparison Tests: It is essential to check totals by the "gross profit test" and the percentage of gross profit should be compared with that of previous years. In a business whose average gross profit has been fairly constant, this test is satisfactory. However, the apparent verification of the inventory by the use of the gross profit test is not necessarily conclusive; and should not be depended upon, to the exclusion of other tests.

Another method of comparison is the tabulation by months, of the sales, cost of goods sold and inventory broken down into the compotent elements of material, labor and overhead.

Such tabulation of the various compotent elements, enables a comparison to be made as regards relative ratios and the possible inclusion of excessive overhead in inventory. Comparisons may also be made with similar statistics of prior periods.

The examination of the sales tabulation by months eliminates the possibility of excessive overstatement of sales in the month immediately preceding the end of the period under examination. However, even this comparison should be made with an eye on the normal course of business of the particular industry under examination because, although the sales for the several months preceding the end of the period have not increased, the normal tendency of the industry might be for a sharp decline in sales during those months.

In the independent scrutiny of the inventory records, determine whether or not the quantities and prices appear reasonable and whether they are in accord with the average consumption and purchases over a fixed period.

Exceptionally large quantities of specific items always deserve special investigation, as overly large stocks of certain items result in unbalanced inventories, a factor that in certain cases may be of primary importance.

In some instances where the product manufactured includes many component parts entering into a finished unit, the inventory may be scrutinized or checked by a "visual breakdown" or "assembling" into completed units, thus determining overly excessive stocks of certain items.

The ratio of inventory to the total yearly sales may be used to determine whether or not the inventory on hand is excessive, by comparing such ratios with similar ratios of other concerns in the same field of activity. Such ratios are now available for many industries as published in various trade associations and government reports.

General: Particular attention must be given to whether or not the internal inventory control is properly coordinated with the financial books, and that such co-ordination is consistently and continually maintained.

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The L. R. B. & M. Journal

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The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest and to help in the solution of common problems.

Federal Tax Handbook

Work is proceeding actively on Colonel Montgomery's new tax book which will bear the above title. A considerable portion of it has already been set up by the printer, and it is expected that the book will issue from the publishers in the course of the next sixty days.

This handbook will contain in compact form information concerning the requirements of the 1932 law respecting the various federal taxes now in force, the position to be taken by taxpayers to protect their interests, and Colonel Montgomery's opinion on ambiguous and disputed points, particularly with respect to the determination of taxable net income.

Almost four years have elapsed since the publication of 1929 Income Tax Procedure, which was a supplement to the 1927 edition. During this period many important decisions have issued from the Board of Tax Appeals and the courts, and the United States Supreme Court has spoken authoritatively on a number of questions which had long been in doubt. Some of these decisions reversed positions held by the Treasury for many years. It follows that the handbook will contain much new matter of an important and helpful nature for taxpayers generally and practitioners in particular.

Audits and Auditors in Germany

It will doubtless surprise readers of the Journal to learn from the leading article in this issue that the Emergency Decrees, promulgated in Germany by President von Hindenburg and former Chancellor von Bruening during the suspension of the powers of the Reich-

stag, were not confined to matters relating to the safety of the nation and the raising of added or increased taxes in the effort to avoid national bankruptcy, but that they also dealt with such matters as the audit of corporate accounts and the qualifications of auditors.

Those who have had an opportunity to become familiar with accounting as practiced in Germany have recognized that the profession of public accountancy in that country was far behind that of the United States and Great Britain in important respects. The right of the German accountant to express an independent and impartial opinion, based on his examination of the accounts of a business, was not adequately recognized. On the contrary, he was rather expected to "sign on the dotted line" if the statements submitted to him were "in accordance with the books." He was indeed a "glorified bookkeeper," so far as his professional freedom was concerned.

The German business man ordinarily considered himself self-sufficient so far as concerned the form and content of financial statements to be issued by the company of which he was director or manager. Such statements were frequently far from the fact as to either financial position or results of operations. To be sure, the divergence was perhaps more often than not on the side of ultra conservatism—at least prior to the World War when German industry was prospering. Nevertheless, the fact remained that, even though the statements under such conditions did not present the facts, there was little the German accountant could, or was expected to, do about it.

As will be seen from the article by Mr. O'Dea, our partner at Berlin, the Emergency Decrees endeavor at one fell swoop to go from a condition of great freedom on the part of directors to one of close definition of the audit of corporations, the financial statements to be issued, and of the qualifications of auditors and their election by shareholders. How well prepared the German accounting profession may be for this broad legal recognition and the serious responsibilities which this brings with it remains to be seen.

A profession cannot be created by mere legal enactment. The development of ideals, principles and procedure is an evolution, of which time and experience are necessary elements. Those American and British accountants who are practicing in Germany will continue to experience a demand for their services, particularly from foreign capital which is invested in German enterprises or from companies which have subsidiaries or branches in that country.

A Silver Anniversary

One of the choicest examples—it might indeed be properly called a gem —of that class of periodicals termed "house organs" came to our hands during the past summer. It was the 25th Anniversary Number of the STONE & WEBSTER JOURNAL.

The make up of this JOURNAL, with its striking cover, excellent typography and numerous illustrations, lures one to dip into its contents. Then one finds a feast of good things contained in it.

The contributors to this anniversary issue are men well known in the fields of business, finance and education. The contributions are both congratulatory and reminiscent in character and present in condensed form the history, ideals and accomplishments of the

Stone & Webster organization and the place of the JOURNAL in the work of the organization.

This anniversary number of the JOURNAL is but another example of the effectiveness with which this proficient organization does any task to which it devotes itself.

Verification of Inventories

(*Continued from Page* 12)

And finally, it must be remembered that there are few rules indeed that can be applied inflexibly.

All methods of verification have not been given, and of those given, not all are applicable to every case. The attention of those wishing to review more fully the various methods of verification is directed to the twenty-two Rules for Verifying Quantities and Other Factors which appear on pages 144-153 of Colonel Montgomery's Auditing Theory and Practice.

Common sense and judgment must always be used.

Corporations and Auditors in Germany

(*Continued from Page* 8)

The object of the first provision is apparently to give the shareholders an opportunity of deciding whether the corporation should contine to operate in the hope of recovering lost ground, or whether they consider it the part of prudence to liquidate before further losses are incurred.

Whereas the first provision above quoted should act as a protection for the shareholders, the second provision is evidently intended to protect the creditors.

The question may here be raised, how are assets and liabilities to be valued, in deciding whether or not, the latter exceed the former. The Commercial Code is silent on the point. The courts and the commentators provide little additional information beyond saying that actual, not merely book, values are to be taken as a basis. As to what constitutes actual value, the commentators make no clear and unanimous statement.

The previous absence of a clause providing for a regular annual examination by independent auditors did, however, tend to render nugatory such provisions as existed for the protection of shareholders and others. This hiatus has now been filled. It might, perhaps, be suggested that it has been filled to overflowing; that an attempt has been made to pour a quart into a pint pot. Despite the excellent propaganda work which has been done by the various German bodies of public accountants, the general public in Germany is still far from realizing the value of periodical audits. The common opinion of an auditor is still, it must be admitted, admirably expressed by a remark uttered by a bookkeeper of the writer's acquaintance: "I was an auditor, too, once; but I managed to get a steady job . . . ."

Whether, in these circumstances, an attempt is not being made to make haste too rapidly, time must decide. The rapid transition from practical absence of independent control to strict surveillance, is almost bound to raise numerous problems in the early stages, and possibly there may be frequent appeals to the law.

In this connection, these notes might close, as they opened, with a quotation from Shakespeare. They shall not, however But those interested may find an apt remark in Macbeth, Act I, Scene VII, Lines 9 and 10.

Notes

The Boston Chapter of the National Association of Cost Accountants, of which Mr. Lester F. Blake of our Boston office has been president during the past year, was awarded the Stevenson Trophy. This is an annual award by the Association to the leader among its forty-one chapters in the dissemination of timely and sound business and management knowledge.

The following paragraph in a letter to Mr. Lybrand from Doctor McLeod, the secretary of the Association, pays tribute to the leadership of Mr. Blake in the winning of the trophy by the Boston Chapter:

> Lester Blake really attained a wonderful achievement. Early in the year when I was in Boston I realized that he was going to make a splendid showing. He proved himself a most inspirational leader and he had his entire group completely lined up behind him. But I do not believe any of us anticipated that he would achieve the winning of the Stevenson Trophy, especially against such keen competition. He certainly did a splendid job—a credit to himself, to your organization and to our Association.

Mr. Blake attended the annual meeting of the N. A. C. A. which this year was held in Detoit.

During the month of July Mr. Staub spent several weeks on the Pacific coast. The primary purpose of his visit there was to attend the annual meeting in San Francisco of the Northern Baptist Convention, of whose finance committee he has been chairman for some years past. He took advantage of this opportunity to visit our offices in San Francisco, Los Angeles, Seattle and Portland.

Mr. Fitz-Gerald has been elected a director of the Detroit Board of Commerce.

An interesting report has just been issued on appraisal standards for the assessment of personal property in Illinois, in the preparation of which the Joint Commission on Real Estate Valuation was aided by a special committee of the Illinois Society of Certified Public Accountants. Mr. H. C. Hawes of our Chicago office was a member of the committee.

Mr. Donald P. Perry was elected President of the Massachusetts Society of Certified Public Accountants at the annual meeting held on May 23, 1932.

Mr. William F. Marsh was elected Chairman of the Pittsburgh Chapter of the Pennsylvania Institute of Certified Public Accountants at the annual meeting held on May 18, 1932. Mr. Marsh has also been elected a director of the National Association of Cost Accountants.

Doctor McLeod's letter to Mr. Lybrand, to which reference is made above, also mentioned the splendid contribution which Mr. Mohle, manager of our Houston office, is making toward the establishment of the N. A. C. A. Chapter in that city.

Mr. M. A. Yockey of our Detroit office has been elected treasurer of the Michigan Society of Certified Public Accountants.

Mr. J. W. Jardine, of our New York office, recently passed the examination for the degree Chartered Accountant (Canada) and has been admitted to membership in one of the Constituent Institutes of the Dominion Association of Chartered Accountants.

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